No. 15073

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

DESSER, RAU & HOFFMAN and JACK L. RAU, individually,

Appellants,

vs.

GEORGE T. GOGGIN, trustee in bankruptcy of Stockholders Publishing Company, Inc., a bankrupt,

Appellee.

Appeal From the United States District Court for the Southern District of California, Central Division.

BRIEF FOR APPELLANTS.

DESSER & HOFFMAN,
DAVID R. NISALL,
JACK L. RAU,
444 North Camden Drive,
Beverly Hills, California,
Attorneys for Appellants.

Parker & Son, Inc., Law Printers, Los Angeles. Phone MA. 6-9171.

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BRIEF FOR APPELLANTS.

This is an appeal from the Order of District Court entered January 11, 1956, approving and affirming the Order of Referee in Bankruptcy, David B. Head, dated August 17, 1955, denying the petition of appellants, Desser, Rau & Hoffman, for an order allowing them to reimburse themselves for out-of-pocket expenses incurred on behalf of the Bankrupt prior to bankruptcy, from a special account created by appellants with funds of the now bankrupt corporation. The order appealed from also approved and adopted the Referee's Findings of Fact and Conclusions of Law. [Tr. 20.]

Statement Disclosing Basis of Jurisdiction.

The jurisdiction of the District Court of the Southern District of California, Central Division, is based upon *Section 1334, Title 28, U. S. C. (Chap. 85).*

The jurisdiction of the Court of Appeals for the Ninth Circuit is based upon *Sections 1291 and 1294, Title 28, U. S. C. (Chap. 83).*

The only pleading in the case is the petition of appellants, Desser, Rau & Hoffman, filed with and addressed to Referee David B. Head, in the matter of Stockholder's Publishing Company, Inc., then an alleged, and since an adjudicated bankrupt, which had done business in the City and County of Los Angeles, and the principal office and place of business of which was in said city and county. The petitioners prayed for leave to set off, retain and reimburse themselves out of funds in their hands belonging to the Bankrupt, the sum of $3,217.68, being actual out-of-pocket expense paid and advanced by petitioners as lawyers in connection with handling the legal affairs of the publishing company prior to bankruptcy. No answer to the petition was filed by the receiver or trustee in bankruptcy.

Statement of the Case.

On January 21, 1955 appellants filed their petition with Referee, David B. Head. The facts alleged were not controverted by answer, were not contradicted by countervailing evidence, are admitted by appellee, and are found as facts by the Referee. [Tr. 7.] Therefore it concededly appears that during the year prior to bankruptcy, from December, 1953, to December, 1954, appellants, in connection with their representation of the present bankrupt corporation, expended of their own funds the sum of $3,217.68 for transportation and hotel accommodations and for long-distance telephone calls, which are itemized in Exhibit "A" to the petition. [Tr. 5.] The petition alleged, and it is not denied, that during the time petitioners represented the bankrupt they never billed it for fees or received any money from it for fees, and that the amount claimed did not represent any charge for fees for services.

On or about December 20, 1954, "for the purpose of protecting its incoming funds and making certain essential disbursement therefrom" [Finding III, Tr. 10], appellants, Desser, Rau & Hoffman, acting as attorneys for the company, and selecting one of their partners, Jack L. Rau, opened at Union Bank & Trust Company of Los Angeles a bank account designated as "Jack L. Rau, Special Account," in which funds of the publishing company were deposited and out of which disbursements were made. [Finding of Fact III, Tr. 10.]

Thereafter, on December 31, 1954, an Involuntary Petition in Bankruptcy was filed in the District Court against the company. Promptly on January 5, 1955, appellants rendered an accounting of receipts and disbursements to appellee George T. Goggin, then Receiver, showing the sum of $16,163.15 remaining in the Special Account, remitting the sum of $12,945.17 to the Receiver and retaining in said Special Account the sum of $3,-217.68, the amount of their said out-of-pocket expense. [Findings IV, V and VI, Tr. 11.]

Appellants, on January 21, 1955, filed the instant petition setting forth the foregoing facts and praying that an order be entered authorizing them to reimburse themselves, out of said Special Account, their said cash advances on the Bankrupt's behalf in said sum of $3,217.68.

[Tr. 3-5.] On the same date the Referee issued an order requiring the Receiver (now Trustee in Bankruptcy and appellee herein) to show cause why an order should not be entered granting the prayer of the petition. [Tr. 5-6.]

Upon the return of the order to show cause no sworn testimony or other evidence was introduced, only informal, and perhaps argumentative, statements being made [Tr. 9], the Referee concluding that, from the face of appellants' petition, it appeared that appellants were not entitled to set off, counterclaim, or retain the amount requested in reimbursement of their cash expenditures. Permission to file briefs, however, was granted, and after the submission of written presentations of their respective positions by appellants and appellee, the Referee denied the prayer of the petition and ordered that appellants, the firm of Desser, Rau & Hoffman, and Jack L. Rau, individually, pay to appellee, George T. Goggin, as trustee, the sum of $3,217.68, the amount held in said Special Account. [Tr. 13.]

In his memorandum of July 25, 1955, which preceded entry of the order and the Findings of Fact and Conclusions of Law [Tr. 6], the Referee held that the facts set out in appellants' petition are admitted as true, but he decided that the prayer of the petition should be denied because a case of mutual debts or credits, such as contemplated by Section 68(a) of the Bankruptcy Act, was not presented. The Referee said:

> "It is clear to me that no mutuality of debts or credits are involved in this matter. Mr. Rau does not hold this fund as his own, but as trustee or agent of the bankrupt. He cannot and does not assert that this fund represents a debt of his to the bankrupt. In fact, the fund held by Mr. Rau is the property of the bankrupt." [Tr. 8.]

This, then, is the basis of the Referee's decision, and, while it seems to state a single and inseparable proposition, and to pose a single question, it found its way into two separate findings of fact and two conclusions of law. These are Findings of Fact VII and VIII and Conclusions of Law I and II.

Finding of Fact VII [Tr. 12] recites:

> "That Jack L. Rau held the moneys in such special account as Trustee or agent of the bankrupt corporation and said Jack L. Rau did not acquire any other interest in said fund."

Finding of Fact VII [Tr. 12] states:

> "That the moneys held by Jack L. Rau in the 'Jack L. Rau, special account' at the Union Bank and Trust Company of Los Angeles constitutes property of the bankrupt corporation."

From these findings the Referee arrived at his only two conclusions of law. Conclusion of Law I [Tr. 12] is as follows:

> "Jack L. Rau held the subject moneys in said special account as trustee or agent of the bankrupt corporation and did not acquire any other interest in said fund."

Conclusion of Law II [Tr. 12] is:

> "There is no mutuality of debts or credits between funds held by petitioners and the obligation of the bankrupt corporation for the funds advanced by petitioners. The funds held by Jack L. Rau on a special account constitute property of the bankrupt corporation."

Considering the Referee's memorandum decision [Tr. 8], together with his findings and conclusions, it would appear, and it is respectfully so suggested, that the Referee (and, by approval and adoption, the District Court on review) actually held as one connected proposition that appellants' counterclaim should be denied because there is no mutuality of debts or credits between the obligation of the bankrupt to appellants for money expended, out of pocket, in the handling of the debtor's legal affairs, and the obligation to the bankrupt and its trustee to pay the entire balance in the special account without deduction, and that there is no such mutuality because Rau held the fund as trustee or agent, not acquiring any other interest therein, the said fund constituting property of the bankrupt corporation. Therefore, in the interests of clarity, this basic, single issue will be so treated in the ensuing specification of errors and in the argument.

The Referee stated in his memorandum opinion, also, that,

> "Before the moneys were turned over to Mr. Rau, his law partner, Mr. Desser, who was a director as well as counsel for the bankrupt corporation, had full knowledge of the insolvency of the bankrupt corporation. At a directors' meeting on December 18, 1954, in which Mr. Desser participated, the directors authorized the president of the bankrupt corporation to institute bankruptcy proceedings. If a transfer of this fund were permitted, it would date from December 20, 1954, or later. This would create a voidable preference under the provisions of Section 60(a) of the Bankruptcy Act." [Tr. 8.]

Appellee did not raise the question of avoidable preference, taking the position that the funds in the special account never left the possession or ownership of the corporation and were not transferred or paid out to appellants or for appellants' use. This was probably the result of appellee's knowledge of the definition of avoidable preferences which contemplates, not a transfer for the debtor's own purposes, as in the case at bar, but a transfer to or for the benefit of a creditor for or an account of an antecedent debt, made while the debtor was insolvent and within four months before the filing of the petition in bankruptcy. Furthermore, the Referee did not follow his memorandum indicating the possibility of an avoidable preference by a finding or conclusion of law to such effect, nor did the District Judge express himself either expressly or impliedly on this subject, except by way of a blanket approval of the Referee's action.

While the order of the Referee of August 17, 1955 [Tr. 9-13], affirmed by the District Court on review by its order of January 11, 1956 [Tr. 19-20], from which this appeal is taken, and the definitive findings [VII and VIII] and the ultimate conclusions of law [I and II] are concerned only with the question of mutuality of debts or credits between the claim of the trustee for the return of the entire fund in the special account and the claim of appellants against the bankrupt and its trustee for out-of-pocket cash expenditures, nevertheless, for the purpose of completeness of presentation, the observation by the Referee on the subject of avoidable preference, will be discussed in this brief.

The main question presented for review is:

1. Does the fact that Jack L. Rau (the partner in the appellant firm designated to hold the funds in the special account by said firm) does not hold the fund as his own, but as trustee or agent of the debtor, and that said fund constitutes the debtor's, not Rau's, property or the property of the appellant firm, remove the case from the operation of Section 68(a) of the Bankruptcy Act which provides, in effect, that in all cases of mutual debts or mutual credits between the bankrupt estate and a creditor, one debt shall be set off against the other and the balance only be allowed and paid?

In other words, does the claim of the bankrupt or its trustee to the balance of the funds in the Jack L. Rau special account and the claim of appellants, Desser, Rau & Hoffman, for money theretofore expended in handling the debtor's legal business, constitute a situation of mutual debts or mutual credits within the meaning of Section 68(a) of the Bankruptcy Act?

In view of the comment of the Referee with respect to the possibility of an avoidable preference, the following question may be stated as ancillary to the foregoing main issue:

2. Would the allowance of appellants' admitted counterclaim for cash, out-of-pocket disbursements, from the funds held in the Jack L. Rau special account constitute a transfer of funds or the approval of a transfer of funds, which would create a voidable preference under Section 60(a) of the Bankruptcy Act?

Specification of Errors.

1. The District Court erred in holding that the claim of the bankrupt and its trustee to the balance of the funds in the "Jack L. Rau special account," and the claim of appellants, Desser, Rau & Hoffman, for money theretofore expended in handling the debtor's legal business, did not constitute a case of mutual debts or mutual credits within the meaning of Section 68(a) of the Bankruptcy Act.

The conclusion of the court was erroneous because the nature or character of the fund and the capacity in which it is held is not determinative of the right to set off or counterclaim. The conclusion is erroneous, moreover, because debts and credits may be "mutual" although the respective causes of action are dissimilar and even though the claim of the bankrupt against its creditor may arise out of a trust or agency relationship in which the counterclaiming creditor holds property, funds or even choses in action of the bankrupt.

2. The Court erred in holding that the allowance of appellants' counterclaim for admitted cash disbursements made on behalf of the bankrupt during the year preceding its bankruptcy, out of funds held in the special account would constitute a transfer, or the approval of a transfer, of funds which would create a voidable preference under Section 60(a) of the Bankruptcy Act.

This general conclusion or observation of the Referee is erroneous because the transfer of funds of the bankrupt to appellants, who created the special account in the name of one of the partners, Jack L. Rau, was not a transfer to or for the benefit of appellants, for or on account of an antecedent debt, as provided in Section 60(a) of the Bankruptcy Act.

Summary of the Argument.

I.

THE CLAIM OF THE BANKRUPT AND ITS TRUSTEE AGAINST APPELLANTS FOR THE PAYMENT AND RETURN OF THE BALANCE OF THE FUNDS IN THE SPECIAL ACCOUNT, AND THE COUNTERCLAIM OF APPELLANTS AGAINST THE BANKRUPT AND ITS TRUSTEE FOR OUT-OF-POCKET EXPENDITURES OF CASH BY APPELLANTS ON THE BANKRUPT'S BEHALF, PRESENTS A CASE OF MUTUAL DEBTS AND MUTUAL CREDITS WITHIN THE MEANING OF SECTION 68(a) OF THE BANKRUPTCY ACT. (TITLE 11, U. S. C. A., SEC. 108(a).)

It is admitted that at the time of the filing of the petition in bankruptcy appellants owed the bankrupt the balance in a special fund created by appellants and placed in the name of one of the appellants' partners, as counsel for the bankrupt, and that, at said time, the bankrupt owed appellants a lesser sum for actual out-of-pocket expense incurred in the handling of the debtor's legal business.

A.

The ultimate ownership by the bankrupt of a fund or property in the hands of one who is also a creditor of the bankrupt, or the nature of the liability or accountability to the bankrupt for the delivery or redelivery thereof, is not determinative of the right to set off or counterclaim for such indebtednes of the bankrupt as against the fund or property of the bankrupt so in the creditor's possession.

Section 68(a) of the Bankruptcy Act provides:

> "In all cases of mutual debts or mutual credits between the estate of the bankrupt and a creditor, the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid."

The District Court's ruling that because the fund was held in a trust or agency capacity and constituted the property of the bankrupt, and the bankrupt's indebtedness to appellants was for cash advances previously made, there was no mutuality of debts or credits, was erroneous because under the authorities, including a controlling decision by this court (*Half Moon Fruit and Produce Co. v. Floyd*, 60 F. 2d 799) it is settled that where a creditor has funds, goods or even choses in action placed in his hands before bankruptcy, a case of mutual debts and credits arises within the meaning of the Bankruptcy Act, to which the doctrine of set-off is applicable.

The courts give a broad construction to the phrase "mutual debts or mutual credits," not confining the doctrine of set-off to identical or similar pecuniary demands, by extending it to all cases where the creditor, who is also a debtor of the bankrupt, has property of the debtor in his hands which cannot "be got at" without an action at law or a proceeding in equity.

B.

Federal Rules of Civil Procedure furnish additional support for appellants' contentions as to the propriety of the allowance of their set-off or counterclaim against the demand of the trustee for the payment of the balance of funds in the special account, because bankruptcy courts proceed under the Federal Rules of Civil Procedure which now specifically authorize set-offs and counterclaims even where not arising out of the same transaction and even where the respective claims are completely different in nature and in substance and in the form of the remedy.

Under General Order No. 37 in Bankruptcy, as amended, Federal Rules of Civil Procedure must be followed in bankruptcy proceedings where not inconsistent with the Bankruptcy Act or with General Orders in Bankruptcy.

Rule 13, Federal Rules of Civil Procedure, provides that any claim may be stated as a counterclaim even though not arising out of the same transaction or occurrence.

This rule is given the most liberal construction by the courts, following its legislative history which discloses that all claims and counterclaims of the parties, no matter how dissimilar in theory or in the nature of the relief, should be determined in a single proceeding.

Rule 13 should be construed together and in harmony with Rule 42(a), Federal Rules of Civil Procedure, which provides for a consolidation of actions.

II.

THE TRANSFER OF FUNDS WITHIN FOUR MONTHS PRIOR TO BANKRUPTCY, BY THE BANKRUPT TO APPELLANTS, DESSER, RAU & HOFFMAN, TO CREATE A SPECIAL ACCOUNT OUT OF WHICH TO PAY CERTAIN OF ITS OBLIGATIONS, WAS NOT AN AVOIDABLE PREFERENCE, AND THE RECOGNITION BY THE COURT OF APPELLANTS' RIGHT TO SET OFF THE BANKRUPT'S INDEBTEDNESS TO THEM AS AGAINST THE BALANCE OF THE FUND EXISTING AT THE TIME OF THE FILING OF THE PETITION IN BANKRUPTCY, WOULD NOT GIVE TO THE AMOUNT SET OFF THE CHARACTER OF AN AVOIDABLE PREFERENCE.

Although the Referee did not find or conclude, in his formal findings of fact and conclusions of law, that the transfer to appellants of funds of the bankrupt with which appellants created the special account constituted, or would, if allowed, constitute an avoidable preference, he did indicate his views on this subject as a matter of law, stating that the *time* of the creation of the special account was, in effect, determinative of the fact that, if the transfer of the bankrupt's funds to appellants were permitted, it would be dated at a time within four months of the filing of the petition in bankruptcy and hence would be an avoidable preference under Section 60(a) of the Bankruptcy Act.

In this the Referee was in error because, under Section 60(a) the time of the transfer is only important if the transfer itself comes within the definition of avoidable preferences.

Section 60(a) defines an avoidable preference as a transfer of property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent, and within four months of the filing of the petition in bankruptcy.

The transfer of the bankrupt's funds into the special account, for its own purposes, was not a transfer to appellants for appellants' benefit for or on account of an antecedent debt of the bankrupt to them.

The special fund was created by a transfer to appellants in the course of the handling of the bankrupt's legal business, and under such circumstances did not constitute, according to the authorities, an avoidable preference.

All preferences are not avoidable and are not *malum prohibitum,* being avoidable only if they come clearly within the prohibition of the Bankruptcy Act.

The trustee in bankrucpty has the burden of proving that the payment or transfer of the debtor's funds or property is an avoidable preference within the strict definition of the Bankruptcy Act.

The trustee failed to make such proof in the present case.

The deduction of the amount of their out-of-pocket expense by appellants from the special fund would be merely the accomplishment of a mutual set-off under the provisions of Section 68(a) of the Bankruptcy Act. The net estate of each remained the same.

The fact that the allowance of the set-off or counterclaim would result in appellants receiving more than their pro rata share of their claim against the bankrupt, as compared with other creditors, does not constitute any reason for disallowance.

The Supreme Court of the United States has held that the real mischief which the Bankruptcy Act purposes to prevent is the acquiring of claims against the bankrupt, when, within four months, it is known to be in financial trouble, for use by way of set-off and reduction of indebtedness to the bankrupt estate. (229 U. S. 138.) The instant situation presents no such problem.

CONCLUSION.

The claim of the bankrupt and its trustee for the payment and return of the funds in the special account and the claim of appellants against the bankrupt for expenses incurred while handling the bankrupt's legal business, constitute a situation of mutual debts and mutual credits, each being indebted to the other in a fixed and liquidated sum of money. Since an avoidable preference cannot be said to exist, appellants are entitled to set-off and counterclaim their demand as against their obligation to the bankrupt under the Bankruptcy Act, under the Federal Rules of Civil Procedure, under the authorities, and in accordance with equity and good conscience.

ARGUMENT.

I.

The Claim of the Bankrupt and Its Trustee Against Appellants for the Payment and Return of the Balance of the Funds in the Special Account, and the Counterclaim of Appellants Against the Bankrupt and Its Trustee for Out-of-pocket Expenditures of Cash by Appellants on the Bankrupt's Behalf, Presents a Case of Mutual Debts and Mutual Credits Within the Meaning of Section 68(a) of the Bankruptcy Act. (Title 11, U. S. C. A., Sec. 108(a).)

As a preface to this argument it may be helpful to restate important record admissions affecting appellants' position.

It is admitted that appellants have, and at the time of, and prior to the filing of the petition in bankruptcy herein had, a just claim against the corporation in the definite sum of $3,217.68, due to them, not as fees for services, but for actual outlays of cash in the handling of the debtor's affairs. Appellants have never billed or charged for their services.

It is admitted that the funds delivered to appellants and deposited in the special account were not paid to appellants or to Jack L. Rau, as their designee, for appellants' benefit on account of any antecedent debt of the corporation to them.

It is admitted that the cash deposits made into the special account were made for the purpose of disbursement on behalf of the corporation and that such special account was created in the course of handling the corporation's affairs by appellants as its counsel.

It is admitted that disbursements for corporate purposes were made, that involuntary bankruptcy intervened which put an end to the use of the fund for which it was designed, that a balance then remained in the account in the sum of $16,163.15, and that an accounting with a check in the sum of $12,945.45 was immediately delivered to the receiver, thus deducting the sum of $3,217.68 pending a determination by the court of appellants' right to off-set this amount of out-of-pocket expense as against the balance in the fund.

A.

The Ultimate Ownership by the Bankrupt of a Fund or Property in the Hands of One Who Is Also a Creditor of the Bankrupt, or the Nature of the Liability or Accountability to the Bankrupt for the Delivery or Redelivery Thereof, Is Not Determinative of the Right to Set Off or Counterclaim for Such Indebtedness of the Bankrupt as Against the Fund or Property of the Bankrupt so in the Creditor's Possession.

Section 68(a) of the Bankruptcy Act provides:

> "In all cases of mutual debts or mutual credits between the estate of the bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid." (Title 11, U. S. C. A., Sec. 108, p. 535.)

The Referee concluded, and the District Court on petition for review agreed, that appellants' counterclaim was not allowable under Section 68(a) because Jack L. Rau did not hold the fund "as his own," but as trustee or agent of the bankrupt, and that, in fact, the fund held by Rau "is the property of the bankrupt." For these reasons it was held that "no mutuality of debts or credits are involved in this matter." [Tr. 8.]

If, of course, Jack L. Rau held the fund "as his own," this case would not be before the court. It is his and the appellant firm's obligation to the bankrupt to account for and repay the unused balance that gives rise to the presence of the counterclaim. Certainly appellants owed to the bankrupt the obligation to turn over funds remaining in the special account. Certainly, also, the bankrupt, simultaneously, owed to appellants the obligation to pay to them their out-of-pocket expenditures on its behalf. Both are simple claims for liquidated amounts of money.

Had bankrupcty not intervened, the situation would present (1) a claim by the corporation for the return of the balance enforceable by a suit for an accounting and a decree for the amount due, and (2) a claim at law by appellants for money expended enforceable by suit at law and a judgment therefor. In such case both claims could be heard, decided and adjusted in one lawsuit, clear right to urge their demand by way of counterclaim being granted to appellants as will be seen by the Federal Rules of Civil Procedure. Each party owing the other a sum of money, they are "mutually" indebted.

The court below, however, took the view that since Rau, in whose name the account stood and who made authorized disbursements therefrom prior to bankruptcy, did not himself personally own the fund and had title to it only as trustee or agent for the publishing company, the counterclaim claim of appellants, who created the special account, could not be allowed. That it was appellants who did so create the special account in the name of their partner is found as a fact by the court below. Finding III recites:

> "That for said purpose, on December 20, 1954, the petitioners, Desser, Rau and Hoffman, acting as attorneys for the bankrupt corporation, opened at the Union Bank and Trust Company of Los Angeles, a bank account designated as 'Jack L. Rau, special account.'" [Tr. 10-11.]

In effect, therefore, the court below concluded that the equitable ownership of the fund by the bankrupt, the trust or agency capacity in which it was held and, above all, the fact that the account was property of the corporation, insulated the fund from any claim by the holder no matter how just and indisputable.

There is nothing in the law of bankruptcy which makes these mutual obligations unmutual. On the contrary, there are many instances where assets, acknowledged property of the bankrupt, were in the hands of creditors of bankrupt who are also its debtors at the time of bankruptcy, who were allowed to set off their claims as against property and funds of the bankrupt then in such creditors' hands.

A case which seems determinative of the question was decided by this court, which held that actual ownership by the bankrupt of goods held under consignment by a creditor, does not operate to preclude the right of set-off under Section 68(a) of the Bankruptcy Act.

In *Half Moon Fruit and Produce Co. v. Floyd,* 60 F. 2d 799 (C. C. A. 9), it appeared that a producer-grower, shortly before bankruptcy, consigned melons to a commission merchant who had made previous and independent advances to the grower for which the bankrupt was indebted to the commission merchant. Judge Wilbur, who rendered the opinion of the court, held that this was a situation of mutual credit which entitled the commisison merchant to set off his independent claim which was in no manner connected with the consignment of the goods in question. In reversing the order of the Referee which was confirmed on other grounds by the District Judge, this court, after quoting Section 68(a) of the Bankruptcy Act, said at page 801:

> "This provision of the statute, borrowed from the English Bankruptcy Act, asserts a broader right of setoff than is usual *because of the broad significance given to the phrase 'mutual credits.'* (Emphasis supplied.) See *Rose v. Hart,* 8 Taunt. 490; *Cullen v. Foster,* 5 Fed. Cas. 305, No. 2519. The rule contended for by Appellant seems to be sustained by the authorities cited. Appellant states: 'It is well settled that where a creditor has goods or choses in action placed in his hands before the bankruptcy under such circumstances that the deposit will result in a debt, as if they are deposited for sale and collection, a case of mutual credit arises within the meaning of the Bankruptcy Act to which the doctrine of setoff is applicable.' "

Speaking further, the court said at page 802:

> "In Murray v. Riggs, 15 Johns. (N. Y.) 571, 592, the court, in dealing with the question of setoff in bankruptcy cases said 'That mutual credit was not confined to pecuniary demands, *but extended to all cases where the creditor had goods in his hands of the debtor and which could not be got at without an action at law or bill in equity.'"* (Emphasis supplied.)

This court then considered the case of *Goodrich v. Dobson,* 30 Fed. Cas. No. 18279, page 1081, where a manufacturer of cloth consigned goods to a New York merchant for sale. In approving that opinion the court said:

> "The property was sold after the bankruptcy and the amount derived therefrom applied upon an outstanding indebtedness owed by the manufacturer to the merchant."

It may be noted that the commission merchant in the *Half Moon* case and the merchant in the *Goodrich* case, by the fortunate circumstance that they held property of the debtor, actually received a preference, but not an avoidable preference. Such creditors are allowed to retain the advantage of their position because their possession of the property of the bankrupt did not come within the definition of avoidable preferences under the Bankruptcy Act.

The "broad significance" mentioned by the court given to the phrase, "mutual credit," is exemplified by *In re W. & A. Bacon Co.*, 261 Fed. 109, 111 (D. C., Mass.). There the creditor had a claim for services in delivering parcels for the bankrupt store prior to bankruptcy. The practice had been for the creditor to pay over the sums collected upon the delivery of the packages every few days. At the time of the bankruptcy the creditor had a sum of money in his hands received as payment for goods delivered for the bankrupt to the bankrupt's customers. The court sustained the creditor in its claim of right to apply such proceeds to the bankrupt's indebtedness. In the *Bacon* case, certainly, the packages delivered to the delivery service were the property of the bankrupt and the funds derived from payments by the customers who received such packages were also property of the bankrupt.

In *Fidelity and Deposit Co. of Maryland v. Duke,* 293 Fed. 661, 665 (C. C. A. 9), the case involved the right of a surety to set off a debt incurred under a contract of suretyship, the debt arising from the fact that the surety had made a payment to the County Treasurer on the bank's default after liquidation had commenced. While this case involved a bank liquidation, it is interesting in its implications. The court said that the rules respecting set-offs and counterclaims were "meritorious and far-reaching" in the adjustment of mutual accounts. "Doubtless it will be conceded," said the court, "that setoff does not depend upon the variety of the contract or the character of the parties."

In considering what are "mutual debts or mutual credits' between the bankrupt estate and the creditor, the court, in *In re Field Heating and Ventilating Co.,* 201 F. 2d 316 (C. C. A. 7), said at page 318:

> "The yardstick for the determination of the right of set-off in bankruptcy is whether the debts are mutual, *that is, whether each owes the other,* and if such reciprocal demand exists, one may be set off against the other, *no matter whether insolvency is present or whether set-off is made before or after bankruptcy intervenes,* for, if the parties have not voluntarily effectuated a set-off prior to bankruptcy, it is the duty of the trustee to do so." (Emphasis supplied.)

The court said also at page 318:

> "As we view the record only one material issue is presented and that is whether the events related bring claimant within the protective provisions of Section 68(a), which provides that 'in all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor, the account shall be stated

and one debt shall be set off against the other, and the balance only shall be allowed and paid.' We keep in mind that to justify set-off it is not necesary that the debts be of the same *character;* claims of *different species* may be set off, if they are mutual." (Emphasis supplied.)

In *In re Rosenbaum Grain Co.,* 103 F. 2d 656 (C. C. A. 7), the court said at page 659:

"The trustee, who has perfected his appeal from the allowance order bases his assignment of errors on the proposition that the obligations or claims in question are not mutual. He contends that the relationship between a stockbroker and his customer is one of pledgee-pledgor, whereas the relationship between the grainbroker and his customers is simply one of creditor-debtor . . . He concludes therefore that the obligations, not owing in the same capacities, are not 'mutual debts or credits.' "

The court, disagreeing with the trustee's contentions, said at page 662:

"We have given serious attention to appellant's brief. To heed the argument made there, in our opinion is to prize form above substance. To argue that the applicability of Section 68(a) of the Bankruptcy Act is dependent upon a possible distinction of a pledge of stock certificates as security and a holding of grain contracts as security is to adhere unnecessarily to technicality. The District Court's order allowing a set-off of the respective obligations is affirmed."

In a footnote to the *Rosenbaum Grain Co.* case appears the following observation:

"In our problem equitable considerations carry great weight."

If equitable considerations are to be given any weight in the case at bar, then, in view of the fact that appellants have made no claim and intend to make no claim for services rendered during the critical year preceding bankruptcy, in the effort to preserve the corporation for its creditors as well as its owners, it would seem that the court should not strain to deny appellants' prayer.

In a single sentence from the opinion in *Studley v. Boylstone National Bank,* 229 U. S. 523, the court indicated the realistic and equitable approach to the claim of the right of set-off. The court said:

> "Such counter claims can be asserted as a defense or as a voluntary act of the parties, because it is grounded upon the absurdity of making A pay B when B owes A."

A court of bankruptcy inquires, what in justice and equity should be done and may be done under applicable principles, to satisfy ordinary rules of fair play. As the court said in *First Naitonal Bank v. Malone,* 76 F. 2d 251, 254 (C. C. A. 8), a set-off is allowed "upon the theory that in good conscience one ought not to pay his creditor if he cannot ultimately compel his creditor to pay the debt due to him."

It is apparent from the authorities that the controlling factor in cases involving the question here presented is that the bankrupt is actually indebted to the creditor, not the technical nature of such indebtedness or of the property in the creditor's hands as to which the creditor attempts to assert a counterclaim. Under the decisions, "mutual debts or mutual credits" means "mutual obligations," that is to say, obligations of each, respectively, to the other. The word "mutual" does not mean identical in character or identical in obligation or enforceable by identical means.

If the bankrupt, prior to bankruptcy, possess claims and demands against others, such claims and demands may be pursued by the trustee either in the bankruptcy court, or, when necessary, by plenary action. If there be defenses to such claims they are assertible against the trustee and it makes no difference whether such defenses be by way of traverse or set-off or counterclaim,—they are equally available. The intervention of bankruptcy works no change in the fundamental rights of the parties beyond the express provisions of the Bankruptcy Act itself.

The "Jack L. Rau special account," to the extent possible prior to bankruptcy, had served its purpose. The undisbursed balance belongs in the general assets of the corporation as part of the bankrupt estate. It was not earmarked for any particular creditor or creditors or for any particular purpose. Had bankruptcy not occurred and had the purpose of the account been fulfilled, leaving a balance, any demand of the corporation for the payment of the remainder could, under the authorities, be reduced by the amount of the debt owed to appellants by the corporation, which could be asserted either by independent action or by set-off or counterclaim. The demand for the balance by the corporation would not, in such case, be predicated on the effort to preserve and continue the special purpose of the original account, but, rather, upon the effort to obtain the amount remaining for use in the general conduct of the corporation's financial affairs and as a part of its general assets. The trustee in bankruptcy stands in the same position. The intervention of bankruptcy does not change the meaning of the words "mutual debts or mutual credits" as that phrase has been interpreted by this and other courts.

B.

Federal Rules of Civil Procedure Furnish Additional Support for Appellants' Contentions as to the Propriety of the Allowance of Their Set-off or Counterclaim Against the Demand of the Trustee for the Payment of the Balance of Funds in the Special Account, Because Bankruptcy Courts Proceed Under the Federal Rules of Civil Procedure Which Now Specifically Authorize Set-offs and Counterclaims Even Where Not Arising Out of the Same Transaction and Even Where the Respective Claims are Completely Different in Nature and in Substance and in the form of the Remedy.

The fact that Rau held the fund as trustee or agent for the bankrupt and not as his own disturbed the Referee to the point that he found it impossible to consider the trustee's claim for the return of the balance in the fund and appellants' claim for reimbursement, in the same proceeding.

The treatment of counter demands is one of the subjects where traditional views as to procedural requirements have yielded to substance and simplicity. It is believed that modern rules of federal procedure have distinct relevance in the consideration of this appeal. Under general order No. 37 in Bankruptcy, as amended by the Supreme Court of the United States on January 16, 1939, it is provided that in proceedings under the Bankruptcy Act the rules of Civil Procedure shall, insofar as they are not inconsistent with the Act itself or with General Orders in Bankruptcy, be followed.

Rule 13 of the Federal Rules of Civil Procedure had the effect of still further broadening the already liberal interpretation given to Section 68(a) of the Bankruptcy Act by the courts. Under Rule 13, all semblance of the older technical requirements, all of the rules and dicta respecting the nature or special character of the indebtedness or indebtednesses as to which there are claims and counterclaims, are swept away in the interests of substantial, quick and economical justice. The rule provides for two kinds of set-offs or counterclaims, compulsory and permissive. Under subdivision (a) of Rule 13, "A pleading *shall* state as a counterclaim any claim which at the time of serving of the pleading the pleader has against any opposing party, *if it arises out of the transaction or occurrence that is the subject matter of the opposing party's claim* . . ." Under subdivision (b) the provision here applicable, "A pleading *may* state as a counterclaim *any claim* against an opposing party *not arising out of the transaction or occurrence* that is the subject matter of the opposing party's claim." (Emphasis supplied.)

The liberality of Rule 13 is manifest from the language of all of its divisions. For example, in subdivision (c) a counterclaim may or may not diminish or defeat recovery and it may claim relief "exceeding in amount or different in kind from that sought by the pleading of the opposing party." Subdivision (e) provides that a counterclaim may be asserted "which either matured or was acquired by the pleader after serving his pleading," with permission of the court. Subdivision (f) allows a defendant, by leave of court, to take advantage of a permissive counterclaim, even where he fails to set it up through oversight, inadvertence or excusable neglect "or when justice requires."

The legislative history of Rule 13, has notably influenced the decisions. Such history reveals an almost limitless breadth of liberality. The extent to which the courts go in allowing set-offs and counterclaims is indicated by such decisions as *Kuenzel v. Union Carloading Co.*, 29 Fed. Supp. 407 (D. C. E. D. Pa.), where a set-off or counterclaim *for goods sold and delivered* was allowed to be interposed *in an action for libel.* The court quoted a discussion of the rule appearing in a Report of the Proceedings of the American Bar Association Institute on Federal Rules (p. 409):

> "Mr. J. R. Keaton (Oklahoma City) Does that mean that if A should sue B for tort, an automobile accident we will say, that B may come back with a promissory note and adjust in the same suit?
>
> Mr. Clark: (Dean Charles Clark of Yale University Law School, Institute lecturer): It certainly does.
>
> Mr. Keaton: All of the claims, whether involving a contract or a tort can be settled in the same suit?
>
> Mr. Clark: Yes."

The court, in the *Kuenzel* case, went on to say:

> "The language of the rule and the above stated interpretation thereof leave no doubt that its effect, meaning and intent permit counterclaiming such as involved in the instant suit . . ."

A further reference to the views of Dean Clark in his discussion of the Rule in the proceedings of the Institute, appears in *Warren v. The Indiana Refining Co.,* 30 Fed. Supp. 281 (D. C. Ind.), where the court said at page 282:

> "The reason given by the very learned members of the committee that drafted the rules for allowing such wide latitude on the subject of counterclaims is expressed by Dean (now Judge) Clark at the Institute held in Washington on Federal Rules of Procedure, as follows, 'that all points of difference between the parties or spots of irritation between the parties should be brought out in the open and should

be fought over and disposed of at one time', is quite persuasive."

The Supreme Court of the United States, in *Chicago Northwestern Railway Company v. Lindell,* 281 U. S. 14, said at page 17:

> "The adjustment of defendant's demand by counterclaim in plaintiff's action rather than by independent suit is favored and encouraged by law. That practice serves to avoid circuity of action, inconvenience, expense, consumption of the court's time, and injustice."

The District Court of the United States for the Northern District of California, in *Pennsylvania Railway Co. v. Musante-Phillips, Inc.,* 42 Fed. Supp. 340, 342 (while the matter before it involved a compulsory counterclaim), expressed complete concurrence with the modern legal view as to set-offs and counterclaims as expressed by the Supreme Court in the United States.

All of the modern decisions considering Rule 13 confirm its wide scope and purpose, freeing litigants from former rules requiring set-offs and counterclaims to arise out of the same transaction, restricting the use of such counter pleading to cases requiring similar relief, and dividing legal from equitable claims.*

Were independent proceedings filed, one by the publishing company for an accounting and return of the unused balance in the special account, and the other by appellants

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*Interesting discussions as to the wide scope and purpose of Rule 13 appear in "Proceedings of American Bar Association Institute" held in Cleveland, page 247; Moore's Federal Practice Volume 1, page 645; Notes of the Advisory Committee on Rules, Title 28 U. S. C. A., page 514, and 25 Virginia Law Review 261. A collection of cases dealing with this subject appears in the Appendix to this brief.

for a money judgment in the amount of their out-of-pocket expenditures, the two cases could, and probably would be, consolidated for the purpose of conserving the time of the court.

Rule 42(a) of the Federal Rules of Civil Procedure provides:

> "When actions involving a common question of law or fact are pending before the court, it may order a joint hearing or trial of any or all the matters in issue in the action; it may order all the actions consolidated; and it may make such orders concerning proceedings therein as may tend to avoid unnecessary costs or delay."

In *Prudential Insurance Co. of America v. Saxe,* 134 Fed. 2d 16, 34 (C. A. Dist. Col.) (cert. den. 319 U. S. 745), it was held that Rule 13 should be construed in harmony with Rule 42 giving the District Court broad discretionary powers for the consolidation of actions involving a common question of law or fact. Certainly appellants' rights to recover out-of-pocket expenditures for the corporation is common to both an action for an accounting and an independent suit for money judgment.

Under the current treatment of set-offs and counterclaims, allowing equitable claims to be set-off against legal demands and vice versa, it would seem that the capacity in which appellants acted with respect to the Jack L. Rau special account, and the capacity in which Jack L. Rau himself acted and the fact that the funds in the special account constituted property of the corporation, are not of controlling significance and present no technical barrier to the successful assertion by appellants of their counter demand or to the deduction of the amount thereof from the funds held in the special account. The court below erred in holding to the contrary.

II.

The Transfer of Funds Within Four Months Prior to Bankruptcy, by the Bankrupt to Appellants, Desser, Rau and Hoffman, to Create a Special Account Out of Which to Pay Certain of Its Obligations, Was Not an Avoidable Preference, and the Recognition by the Court of Appellants' Right to Set Off the Bankrupt's Indebtedness to Them as Against the Balance of the Fund Existing at the Time of the Filing of the Petition in Bankruptcy, Would Not Give to the Amount Set Off the Character of an Avoidable Preference.

There is irreconcilable inconsistency between the idea that the fund as against which appellants seek to set off their claim was and remained the property of the bankrupt which was not nor was any part thereof ever transferred to appellants in such manner as would confer upon them or their agent, Rau, any personal interest or individual right, and the idea that such transfer was a preferential payment to appellants avoidable under Section 60(a) of the Bankruptcy Act.

The trustee took the position, which the court below approved, that the corporation did not transfer the fund to the appellant firm or to Rau, their designee, and the account never lost its character as the property of the bankrupt. If this be true, then there could be no preference avoidable under the Bankruptcy Act. As has been seen, the fact that the fund was the property of the bankrupt does not prevent a set-off or counterclaim against it. It was, perhaps, in partial recognition of the soundness of appellants' contentions in this respect that impelled the Referee to insert in his memorandum his observation with respect to avoidable preferences. And the evident reason for this statement by the Referee was the lateness of the date at which the fund was given to appellants to create the special account. In his opinion the Referee said [Tr. 8], "If a transfer of this fund were permitted, it would date from December 20, 1954, or later. This would create a voidable preference under the provisions of Section 60(a) of the Bankruptcy Act."

It should be observed, however, that the *date of the transfer* is only important if the transfer itself comes within the purview of the statute, *i. e., a transfer to or for the benefit of the creditor for or on account of an antecedent debt.* The popular impression that *any* transfer of funds or property by an insolvent debtor within four months of the filing of the petition in bankruptcy is an unlawful preference, seems to have sometimes permeated the thinking of referees, trustees and even District Courts. But the commendatory effort to build up and preserve assets of the general estate for the benefit of general creditors (which incidentally has a direct bearing upon the size of allowable fees) does not justify a departure of the plain meaning of a statute or from sound principle. The purpose of the bankruptcy courts, in situations where the bankrupt occupies the position of both creditor and debtor to another, is to obtain for the estate the net balance, if any, due to or from the bankrupt.

Here appellants, and Jack L. Rau, their designee, at the time of intervention in bankruptcy, owed the bankrupt \$16,163.15. Whether they owed this amount as an ordinary debtor or as trustee or agent makes no difference under the authorities cited under Point I above. At the same time the bankrupt owed appellants the sum of \$3,217.68. The net balance due to the bankrupt was \$12,945.47 which was remitted to the receiver. The net balance as it existed at the time of bankruptcy will not be disturbed unless the bankrupt, by transferring funds to the special account, can be said to have preferred appellants unlawfully in so doing. The element of deliberate preferential treatment, essential to condemning a transfer by the debtor to its creditor as an unlawful and avoidable preference, is wanting.

In the vast majority of cases wherein the creditor is regarded as having been illegally preferred, such creditor occupied the position of creditor only, owing nothing to the bankrupt. Whether or not the transfer of funds to appellants to create the special account, or the subsequent deductions of the amount of the counterclaim (as to which the debtor did not participate) can be said to constitute an avoidable preference depends upon the language of Section 60(a) of the Bankruptcy Act. This section provides:

> "A preference is a transfer, as defined in this title, of any property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent, and within four months before the filing by or against him of the petition in bankruptcy. . . ." (Sec. 60(a) of the Bankruptcy Act is Title II, Sec. 96(a), U. S. C. A.)

The only restriction upon the right to present a set-off or counterclaim as against a trustee in bankruptcy is that such set-off or counterclaim will be disallowed only when not provable against the estate and allowable under subdivision (g) of Section 57 of the Bankruptcy Act. (Title II, Sec. 93(g), U. S. C. A.) This section provides:

> "The claims of creditors who have received or acquired preferences, liens, conveyances, transfers,

> assignments or encumbrances, void or voidable under this title, shall not be allowed unless such creditors shall surrender such preferences, liens, conveyances, transfers, assignments, or encumbrances."

Turning to Section 60(a) of the Bankruptcy Act wherein the definition of avoidable preference is found, we have seen that a preference, to be an avoidable preference, must be a transfer of the property of a debtor "to or for the benefit of a creditor for or on account of an antecedent debt." It is, under Section 60(b), as to *"any such preference"* that the knowledge of insolvency becomes relevant.

Under the admitted facts the transfer of funds by the bankrupt to the appellant firm, who created the Jack L. Rau special account, did not come within the purview of an avoidable preference as defined by the act. The funds in the special account were not transferred to appellants or to one of their partners, Jack L. Rau, "to or for their benefit" as creditors, or "for or on account of an antecedent debt" due to them. The fund was created in the course of business of the debtor corporation to be administered by appellants for the corporation's benefit and disbursed upon its obligations.

Whether or not a transfer or payment by a debtor constitutes a voidable preference must be determined as of the time of such transfer or payment, not by events occurring after bankruptcy. The question is, were the deposits in the special account, at the time they were deposited, made to or for the benefit of appellants for or on account of an antecedent debt due from the bankrupt to them? The funds and the deposits in the fund are not claimed by appellants as a payment to or for them or upon an antecedent debt due to them. Their position is that, having lawful possession when the petition in bankruptcy was filed of a balance of the fund originally delivered to them for corporate purposes, which balance constituted a claim against them for its return, they have a concomitant right of set-off for the amount due to them. Any advantage they may have received arises, not from a preferential payment or advance to them, but from the right to set off their claim, a right especially conferred by the Act when bankruptcy intervenes. In effect, the set-off provision of the Bankruptcy Act merely preserves, after bankruptcy, the rights and liabilities *inter se* which existed prior to bankruptcy. The fund was created in the course of handling the legal business of the debtor corporation, to be administered by appellants through Jack L. Rau, their partner, for the client's benefit and disbursed on its obligations.

Preferences are not *malum prohibitum* and are voidable only when they come within the express prohibitions of the statute. In 8 Corpus Juris Secundum, Section 213, page 696, it is said:

> "In view of the fact that, at common law and in the absence of statutory prohibition, an insolvent debtor has the right to prefer one creditor over others, a trustee in bankruptcy must derive from some provision of the Bankruptcy Act whatever right he may have to avoid an alleged preference by the bankrupt. A preference is *malum prohibitum* only to the extent that it is prohibited by the Act."

To the same effect are *Von Iderstine v. National Discount Co.*, 227 U. S. 575, 582; *Coleman v. Potter Title and Trust Co.*, 4 Fed. Supp. 743, 744 (D. C. W. D. Pa.).

In claiming a preference the trustee in bankruptcy has the burden of proving that the payment or transfer of the debtor's funds or the transfer of the debtor's property is an avoidable preference within the strict definition of the Act.

In *Barry v. Crancer,* 192 F. 2d 939 (C. C. A. 8), the court said:

> "We know of no holding and we do not understand that appellant (the trustee in bankruptcy) contends that the action under 11 U. S. C. A., Sec. 96, Subdivision (b), for recovery on account of a voidable preference may be maintained without allegation and proof of a preference within the definition of 11 U. S. C. A., Sec. 96, Subdivision (a)."

In *Canright v. General Finance Corporation,* 123 F. 2d 98, 100 (C. C. A. 7), the court said:

> "To be sure, the law presumes that the payment is legal. To overcome this presumption and establish the essential elements of a voidable preference, the burden of proof is on the trustee."

To the same effect are *Continental and Commercial Trust and Savings Bank v. Chicago Title and Trust Co.,* 229 U. S. 435, 443; *Walker v. Wilkinson,* 296 Fed. 850, 853 (C. C. A. 5; cert. den. 265 U. S. 596); *Dinkelspiel v. Weaver,* 116 Fed. Supp. 455, 459.

A case pursuasively in point is the much cited authority, *In re Field Heating and Ventilating Co.,* 201 F. 2d 316 (C. C. A. 7), where the court held that where the right of set-off exists questions as to whether or not the creditor had, at the time of the transfer, reasonable cause to believe that the debtor was insolvent, and similar questions were unimportant and immaterial. In that case, Northbrook Homes, Inc., a creditor of the bankrupt, filed a claim against the debtor's estate for $3,289, a balance on an indebtedness due from the bankrupt for money borrowed in the sum of $11,000, which amount had been reduced by set-off credits to the sum of $3,289. The trustee in bankruptcy filed a counterclaim in which he averred that the credits by which the claimant reduced its demand had been obtained by means of payments made by the bankrupt under such circumstances as to amount to a preference voidable under the provisions of the Bankruptcy Act. Answering the counterclaim of the trustee, the creditor asserted that the credits did not amount to a preference but were, in legal effect, merely the accomplishment of a mutual set-off under the provisions of Section 68(a) of the Bankruptcy Act. The Referee found the creditor's claim was an avoidable preference recoverable by the trustee, and the District Court approved the conclusions of the Referee and entered judgment accordingly. The opinion of the Court of Appeals reversing the judgment is so important to the present situation that, for the convenience of the court, it is quoted at considerable length. At page 318 the court said:

> "In February, 1951, claimant owed the bankrupt for construction work done for it by the latter; the bankrupt owed claimant for borrowed money. If either had brought suit, the other might have pleaded set-off. Instead of doing so, they exchanged checks. neither took anything from the other's estate. Their trial balances of accounts payable and receivable recorded only a reduction of accounts payable in one instance and of accounts receivable in the other balancing each other. The net estate of each remained the same both before and after the checks

were exchanged. Thus the essential element of a preference, *i. e.,* something which diminishes the estate, National Bank of Newport v. National Herkimer County Bank, 225 U. S. 178, 184, 185, 32 S. Ct. 633, 56 L. Ed. 1042, is lacking. We can conceive of no more appropriate application of the doctrine of set-off than that presented here. Prudential Insurance Company v. Nelson, 101 F. 2d 441, 443.

"The trustee argues that to approve the set-off here is to permit claimant to recover more than its pro rata share of its debt as compared with other creditors. Such is always the result of true set-offs under the Bankruptcy Act. As the Supreme Court in New York County National Bank v. Massey, Trustee, 192 U. S. 138, 147, 24 S. Ct. 199, 201, 48 L. Ed. 380, said: 'It is true that it (the deposit) creates a debt, which, as the creditor may set it off under Section 68, amounts to permitting a creditor of that class to obtain more from the bankrupt's estate than creditors who are in the same situation and do not hold any debts of the bankrupt subject to set-off. But this does not, in our opinion, operate to enlarge the scope of the statute defining preference so as to prevent set-off in cases coming within the terms of Section 68(a). If this argument were to prevail, it would, in cases of insolvency, defeat the right of set-off recognized and enforced in the law, as every creditor of the bankrupt holding a claim against the estate subject to reduction to the full amount of a debt due the bankrupt receives a preference in the fact that, to the extent of the set-off, he is paid in full.' "

Then quoting from *Studley v. Boylston National Bank,* 229 U. S. 523, the court said at page 528:

"If this set-off of mutual debts has been lawfully made by the parties before the petition is filed, there

> is no necessity for the trustee doing so. If it has not been done by the parties, then, under command of the statute, it must be done by the trustee."

Another case of similar import is *Addington v. Forsythe Metal Goods,* 136 N. E. 305 (N. Y., 1922), where a bankrupt made a contract for the manufacture of certain articles of merchandise, advancing payment on the contemplated future deliveries. Within four months bankruptcy intervened and the articles had not been manufactured. The bankrupt was indebted to the manufacturer on a balance due under a previous contract. The court held that this old balance could, under Section 68(a), be charged by the manufacturer and set-off or counterclaimed against the deposit. Application for certiori was denied by the Supreme Court of the United States, 263, U. S. 700.

Courts have always been intent upon achieving substantial justice through the medium of set-off and counterclaim. They have ever disregarded the fact that the practical result of allowing a set-off is to diminish payment to other creditors. This was decided as long ago as 1872. In *Drake v. Rollo,* 7 Fed. Cas. No. 4066, page 1035, a case in which an insurance loss was permitted to be counterclaimed against an indebtedness to the insurance company, the court said:

> "It is true in this case the plaintiff obtained part of the means which the company possessed with which to meet its liabilities in case of loss, and by permitting a set-off which enables plaintiff to receive payment in full of his claim, while general creditors are only partially paid, and thus he becomes a preferred creditor. But it is a *preference growing out of the business relations of the parties* as they stood

> at the time of the fire which rendered the company insolvent." (The court had reference to the great Chicago fire of October 9, 1871.) (Emphasis supplied.)

For at least a year prior to bankruptcy, appellants, as is conceded, performed extensive services for the publishing company, requiring among other things two trips to New York, two to San Diego, one to San Francisco and one to Chicago, all, doubtless, in the effort to save and preserve the company and its newspaper, "The Daily News," for the stockholders and its creditors. No claim for such services has been or will be filed. But in connection with their efforts, appellants expended a substantial sum of money which was never paid. It was in the course of this business and professional relationship and in connection with the services performed, that the funds with which the special account was created came into their hands. If this could be regarded as a preference, it is, as in *Drake v. Rollo,* "a preference growing out of the business relations of the parties."

That the approval of the counterclaim might result in appellants obtaining "more from the bankrupt estate" than general creditors, does not "operate to enlarge the scope of the statute defining preferences."

> *In re Field Heating and Ventilating Co.*, 201 F. 2d 316, 318;
>
> *New York County National Bank v. Massey, Trustee,* 192 U. S. 138, 147;
>
> *Studley v. Boylston National Bank,* 229 U. S. 523, 538.

The instant situation does not come within the purview of avoidable preferences as intended by the Legislature. The Supreme Court of the United States, in *Continental and Commercial Trust and Savings Bank v. Chicago Title and Trust Company,* said that the purpose of the statute is to prevent the acquiring of claims of others against the bankrupt for use by way of set-off and reduction of indebtedness to the bankrupt estate. 229 U. S. 435, 443, 447.

In that case the Supreme Court said further:

> "To constitute a preferential transfer within the meaning of the bankruptcy act there must be a parting with the bankrupt's property for the benefit of the creditor and a consequent diminution of the bankrupt's estate."

It is submitted that, under the circumstances, to hold that the transfer of the fund here in controversy, constitutes an avoidable preference, would be to strike from Section 60(a) the language, "to or for the benefit of the creditor for or on account of an antecedent debt." This would do violence to the plain language of the statute and would contravene the unmistakable legislative intent.

Conclusion.

At the time of the filing of the petition in bankruptcy herein appellants and Jack L. Rau owed the bankrupt a sum of money. The fact that the indebtedness might be said to arise out of an obligation as trustee or agent is of no real consequence. As this court said, "It could not be got at without an action at law or a bill in equity." (*Half Moon Fruit and Produce Co. v. Floyd,* 60 F. 2d 799.) The liability of appellants was to pay a liquidated sum of money. At the same time the bankrupt owed appellants a fixed amount for cash advances. Appellants' real indebtedness at that point in time was the actual net difference between these two mutual obligations. Since there is nothing in the Bankruptcy Act, and nothing in equity and good conscience which gives to the trustee in bankruptcy a greater or a different right as creditor, or a lesser obligation as debtor, there would seem to be no sound or sensible reason why the normal balance so struck should not be confirmed and the prayer of appellants' petition granted. It is urged that the order of the District Court be reversed with directions to allow appellants to reimburse themselves from the special account in the amount of $3,217.68.

Respectfully submitted,

DESSER & HOFFMAN,

DAVID R. NISALL,

JACK L. RAU,

Attorneys for Appellants.

APPENDIX.

The following is a list of cases illustrating the liberal attitude of courts with respect to set-offs and counter-claims.

In *Abraham v. Selig,* 29 F. Supp. 52 (D. C. N. Y.), the court said that a party "may claim relief different in kind from that sought by the opposing party." That case went so far as to hold that a counter-claim against individual partners could be asserted in an action upon a partnership claim in the interest of avoiding a multitude of suits.

In *Gallahar v. Rheman Co.,* 50 F. Supp. 655, 661 (D. C. S. D. Ga.), it was said that the philosophy of Rule 13 and others of the Federal Rules is to discourage separate actions which make for a multiplicity of suits, and wherever possible to permit, and frequently require, combining in one litigation all of the claims and cross-claims of the parties.

In *Kuenzel v. Union Carloading Co.,* 29 F. Supp. 407, 409 (D. C. E. D. Pa) (heretofore cited) the court said that these rules are designed to enable the disposition of a whole controversy of interested parties' conflicting claims, at one time and in one action.

In *Brown Paper Mill Co. v. Agar Mfg. Corp.,* 1 F. R. D. 579, 580 (D. C. N. Y.) the court said that Rule 13 was enacted for the purpose of dispensing with needless independent actions when those existing causes of action might be brought as permissive counter-claims against an opponent.

In *Wyckoff v. Williams,* 121 N. Y. S. 189, the court went so far as to hold that a set-off should be allowed where injustice would otherwise result, even though an action at law could not be maintained on the claim in question.

Other cases which decide that the parties, whenever possible, should adjust all of their difficulties in one lawsuit, are the following:

Moore's Federal Practice, Vol. 1, pp. 684, 701;

Marks v. Spitz, 4 F. R. D. 348, 350 (D. C. Mass.);

Carter Oil Co. v. Wood, 30 F. Supp. 875, 877 (D. C. E. D. Ill.);

Arizona Lead Mines v. Sullivan Mining Co., 3 F. R. D. 135, 139 (D. C. Ida.);

Lesnik v. Public Industrial Corp., 51 F. Supp. 989, 992 (D. C. N. Y.);

Seagram Distillers v. Monos, 25 F. Supp. 233, 234 (D. C. W. D. So. Car.);

Madison Mercantile Products v. Frank, 7 F. R. D. 615, 616 (D. C. N. J.);

Ohio Casualty Ins. Co. v. Maloney, 3 F. R. D. 341, 342 (D. C. E. D. Pa.).